VZCZCXRO9416
RR RUEHCHI RUEHDT RUEHHM RUEHNH
DE RUEHKL #1462/01 2700858
ZNR UUUUU ZZH
R 270858Z SEP 07
FM AMEMBASSY KUALA LUMPUR
TO RUEHC/SECSTATE WASHDC 0029
INFO RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/USDOC WASHDC
RUEHGV/USMISSION GENEVA 1512
RUCNASE/ASEAN MEMBER COLLECTIVE

UNCLAS SECTION 01 OF 02 KUALA LUMPUR 001462

SIPDIS

STATE PASS USTR - WEISEL AND JENSEN
STATE PASS FEDERAL RESERVE AND EXIMBANK
STATE PASS FEDERAL RESERVE SAN FRANCISCO TCURRAN
USDOC FOR 4430/MAC/EAP/J.BAKER
TREASURY FOR OASIA AND IRS
GENEVA FOR USTR
SENSITIVE

SIPDIS
E.O. 12958: N/A
TAGS: ECON EFIN EINV MY
SUBJECT: Islamic Finance in Malaysia Part 2: Obstacles and Opportunities

REF: Kuala Lumpur 1429

¶1. (U) Summary: Malaysia is determined to become a global hub for Islamic Finance, and already accounts for two thirds of outstanding Islamic bond issuances (reftel). However, at a recent conference in KL, financial experts discussed a number of obstacles holding back development of this niche market. Chief among them was the inadequacy of the secondary market and the lack of Islamic derivative products. Higher legal fees and complications arising out of the need for Sharia compliance were a burden as well. Nevertheless, the Malaysian government remains optimistic and content to have a pragmatic approach to development rather than get hung up on the need for a "purist" approach to Sharia compliance. End summary.

Central Bank Governor Claims 40% Annual Growth in Islamic Bonds

¶2. (U) At the 2nd Malaysian Islamic Finance Conference in Kuala Lumpur last month, Central Bank Governor Dr. Zeti Akhtar Aziz announced that Malaysia accounted for about two-thirds of outstanding Islamic bonds throughout the world, amounting to roughly US$47 billion in 2007. High savings rates in Asia and the Middle East were driving demand, she said, resulting in an average growth rate of 40% per year in the scale of the Islamic bond market.

How to Build the Industry

¶3. (U) While Governor Zeti focused largely on Malaysia's success with Islamic bonds, other speakers at the conference focused on what needed to be done to build the industry. Malaysia's RHB Islamic Bank chairman Vaseehar Hassan urged Malaysian Islamic banks to venture overseas and establish links with Middle Eastern markets, while also calling for non-Malaysian banks to issue Islamic bonds in Malaysia.

Still a Developing Capital Market

¶4. (U) Investors at the conference complained that the Islamic derivative market was inadequate, and that there was almost no secondary domestic market for Islamic products. There are simply too few players and intermediaries, they commented, so most investors prefer holding their investments. Moreover, few Islamic

derivative products exist. Some investors also accused banks of not being transparent in risk management due to the lack of Islamic derivatives for hedging purposes. Similarly, international rating agencies have noted the difficulty in rating Islamic products as there are few products for benchmarking. In the case of Islamic REITs (Real Estate Investment Trust), Moody's Representative Director Christina Maynes said it was very much a conventional REIT in Malaysia's case. However, she commented that Middle Eastern investors generally preferred to invest in real estate directly.

Double the Legal Fees

¶5. (U) Issuers complained about the difficulty and higher cost in coming up with Sharia-compliant products. Legal fees essentially double with the added layer of a board of Islamic scholars who must adjudicate Sharia-compliance.

Sharia-compliance a high bar to meet

¶6. (SBU) In addition, Sharia compliance is stringent: in addition to the basic prohibitions, like alcohol, gambling, etc., income from interest and debt to asset ratios must be below certain thresholds. Ed Teather, Executive Director and Senior Economist for ASEAN Research, told ECONOFF that these kinds of requirements made Islamic finance theoretically viable for refinancing existing assets, but nearly impossible to finance a new initiative that exists only as a blueprint or a business plan. In addition, he pointed out that with the current excess liquidity in the market it simply did not make economic sense for corporations to go to the added trouble and extra expense of issuing Islamic products.

Shortage of experts

¶7. (U) Yet another barrier is a lack of skilled Islamic finance professionals. Banking professionals are seldom proficient in Sharia, while Islamic scholars are seldom proficient in finance. The GOM is providing scholarships to Malays who want to study Islamic finance and has established a training entity funded and coordinated through the Central Bank. The 2008 budget proposes to exempt expatriate Islamic finance professionals from paying income tax in an effort to attract more talent from the Middle East.

Working Towards Becoming "Purely Islamic"

¶8. (U) Islamic finance, as it is currently practiced, is not regarded as "pure" by many practitioners and scholars. However, there is a general consensus among these experts on the need to build the industry until it can become independent of the global conventional finance system. Until then, interest rates remain the fundamental benchmark for pricing and the mingling of Islamic and conventional assets will continue.

¶9. (U) Islamic finance, which forbids charging interest, uses an underlying asset to structure a "trade" as a substitute for a loan. For example, a contract is written to buy a specific amount of wheat and then re-sell the wheat at a specified later date at a different price. The price difference can be used to finance an entirely unrelated transaction. The concept of the time value of money is ignored, and the difference between the purchase and resale price is attributed solely to risk. A blind eye is turned to the fact that compensation for "risk" is equal to what a conventional bank would charge in interest, and this "risk" even can be compounded daily. Practitioners acknowledge this and other "impurities" in how Islamic finance is carried out, but hope that someday the industry will grow big enough to establish its own benchmarks.

¶10. (SBU) The concerns of some practitioners go further. Rafe Haneef, Citibank's Head of Islamic Finance for Asia, told ECONOFF that in order to truly practice Islamic finance, one had to be

concerned about what the next customer did with the wheat even after the Islamic bank no longer held title to it. The wheat could be sold for consumption, but once it had been used in an Islamic transaction, it should not be used in any interest-bearing transaction. He said this would be "like selling grapes to a winemaker."

¶11. (SBU) Because the market for Islamic finance remains small, some mingling of funds is inevitable, as there simply are not enough Islamic financial products available. "All roads lead to U.S. Treasury bonds eventually," explained David "Daud Abdullah" Vichary, a longtime Islamic finance practitioner and British national. As the same money gets circulated, it is impossible to shelter it from conventional finance, he told ECONOFF.

Comment

¶12. (U) Whether or not Islamic finance will overcome its obstacles and become a major global industry remains an open question. The vision of its promoters is to tolerate a bit of un-Islamic "impurity" for now out of necessity, but to gradually move toward a "purer" form as the industry grows. In Malaysia, with the government in an activist mode, the approach to Islamic finance is more pragmatic than pure, and it appears to be a growing reality.

KEITH